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IN THE

Supreme Court of the United States

No. 287.

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR PETITIONER.

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COMMISSIONER OF INTERNAL REVENUE,
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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR PETITIONER.

This case comes before the Court on writ of certiorari issued to review a decree of the United States Circuit Court of Appeals for the Third Circuit.

OPINIONS BELOW.

The opinion of the Tax Court of the United States, written by Judge Opper, from which Judges Smith, Arundell, Van Fossan, Black and Tyson dissented, together with the dissenting opinion by Judge Smith, promulgated February 28, 1945, appears in the Record at pages 89a to 104a, and is reported at 4 T. C. 897. The opinion of the United States Circuit Court of Appeals for the Third Circuit on the original argument, written by Circuit Judge O'Connell, was filed January 8, 1946, and appears in the Record at pages 106 to 116 inclusive. This opinion was withdrawn by the Court April 8, 1946 (R. 125-126) and was not officially reported. The opinion of the majority of the Circuit Court of Appeals on rehearing, written by Circuit Judge O'Connell was filed April 16, 1946, and appears in the Record at pages 126 to 136 inclusive and is reported at 155 F. (2d) 237. The dissenting opinion by Judges Maris and Goodrich on rehearing, filed the same day, appears in the Record at pages 137 to 140 inclusive, and is reported at 155 F. (2d) 244.

JURISDICTION.

The jurisdiction of this Court to review the judgment of the Circuit Court of Appeals for the Third Circuit on writ of certiorari is provided by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938, 28 U. S. C. A. Sec. 347), and Section 1141 (a) of the Internal Revenue Code (53 Stat. Part. 1, 164, 26 U. S. C. A. Sec. 1141). The judgment of the United States Circuit Court of Appeals was entered on April 16, 1946. (R. p. 141.) Petition for writ of certiorari was granted by this Court on October 14, 1946.

QUESTIONS PRESENTED

1. Did the receipt by petitioner of debenture bonds (together with new common stock) of J. Robert Bazley, Inc., pursuant to the Plan of Reorganization of that Corporation duly adopted, whereby the entire 1,000 shares of previously outstanding $100 par stock (including petitioner's 798 shares) were exchanged for its 5,000 new no par shares *and* $400,000 6% debenture bonds, give rise to a non-recognized gain, the taxation of which was postponed under Sections 112 (b) (3) and 112 (g) of the Internal Revenue Code, or did it constitute a dividend taxable under Section 115 (g)?

2. Under *Gregory v. Helvering*, 293 U. S. 465, must it affirmatively appear, in order that such "recapitalization" come within Sections 112 (b) (3) and 112 (g), that it was adopted and carried out for the benefit of the *corporation* as distinguished from a benefit to *stockholders*?

3. Was the Plan adopted and carried out pursuant to a "legitimate corporate business purpose"?

4. If the receipt of such debentures with such new common stock in the exchange for old common stock (which petitioner had held for nine years) did *not* constitute such a "recapitalization", was not the gain realized therefrom a gain from an exchange, taxable as capital gain under Sections 112 (b) (2), 112 (c) (1) and 117?

STATUTES INVOLVED.

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations are set forth in Addendum A.

STATEMENT OF THE CASE.

In 1939 petitioner's company, of which he and his wife owned practically all the outstanding stock (1,000 $100 par shares) was engaged in the contracting business, principally in "stripping" the earth and rock overlying veins of anthracite coal. This business being then very poor, petitioner's Company considered going into the hazardous business of road building which, as found by the Tax Court (R. 91a) "requires considerable working capital", and in which "many road-building contractors have failed". The Company having accumulated a surplus of $855,783.82, most of which had been ploughed back into plant and equipment, it was deemed advisable to rearrange the company's capital structure so that less would be represented by the stock, both in order to leave less at the risk of the business and in order to reduce the unit value of the shares. Accordingly, a recapitalization was duly effected under Pennsylvania law, the outstanding 1,000 shares of $100 par stock being exchanged for 5,000 no par shares and $400,000 principal amount of 20 year 6% debenture bonds.

The Tax Court found four "reasons for adopting the transaction" (R. pp. 91a-92a):

1. The stockholders, in receiving in exchange for the outstanding 1,000 shares, debentures as well as no par stock, would have, in part, a more marketable security, which would be particularly advantageous where necessary to liquidate a part of a deceased stockholder's investment in order to meet inheritance taxes and other expenses.

2. The debentures could be sold by the stockholder where necessary without reducing the stock control in the management of the Company.

3. The debentures would constitute a preferred obligation which, in case of eventual reverses incident to the hazardous road building in which the company was embarking, would share with creditors.

4. By reason of the fact that a large part of the company's earnings had been reinvested in fixed assets, it was deemed proper that the part of the earned surplus represented by the increased stated value of the common stock and by the par value of the bonds should be transferred from earned surplus to capital, and no longer be available for dividends, but "reflect a more permanent dedication to corporate use of these earnings".

The Tax Court refused to credit petitioner's testimony that an additional reason was that petitioner and his associates deemed it desirable, by reducing the unit value of the stock, to make it feasible to sell some of it to the key employees and so give them a stake in the business,—because this had not in fact been done up to the time of the hearing. Petitioner, while pointing out that the company's capital structure had in fact been altered so as to make such a future sale feasible, does not, for the purpose of this appeal, dispute the Tax Court's finding.

The Tax Court held that the four reasons which it found had motivated the recapitalization were all reasons which benefited the *stockholders* as distinguished from the *corporation*. Construing this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465, a majority of the Tax Court held, (applying such construction for the first time in this case) that, although this was a transaction within the terms of section 112 (b) (3) [1] of the Act, and although the debentures were admittedly "securities" thereunder, nevertheless, in order for a recapitalization or other reorganiza-

(1) Sec. 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Sec. 112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

tion to come within such provisions it must have been undertaken for and result in a benefit to the *corporation* as distinguished from one to the *stockholders;* accordingly, since the majority of the Tax Court found no corporate business purpose, it held that the transaction was not within sections 112 (b) (3) and (g) and was therefore subject to tax. They also refused to recognize any benefit to the corporation in the alteration of its capital structure in the manner which the stockholders desired, or in the saving of taxes to the corporation by the deduction of the annual interest charge on the debentures.

Five of the sixteen Judges of the Tax Court dissented.

The Circuit Court, Judges Maris and Goodrich dissenting, upheld the position of the majority of the Tax Court.

The second point in the case was, assuming that the transaction did not constitute a tax-free reorganization because lacking a "corporate business purpose," nevertheless, since under the express allegations and admissions of the Commissioner and the express findings of the Tax Court it constituted a *single unitary transaction,*—the receipt of the new stock *and* debentures *in exchange* for the old stock, which had been held for 9 years,—any resulting gain was taxable as a *capital gain* under Section 117.

On this second point the Tax Court attempted no logical reconciliation of its *finding of fact* [2] that the transaction was a unitary exchange of old stock for new stock *and* debentures, with its *conclusion* that the distribution of the debentures was a taxable dividend. The Circuit Court in its original opinion (R. pp. 106-116), attempted to sustain the Tax Court's conclusion by revising the Tax Court's express finding that the transaction was a single exchange of old stock for new stock and bonds, and by dividing the transaction into two distinct steps,—an exchange of the old stock for new stock "followed by a distribution of the 20-year debenture bonds." The Circuit Court's attention having been called, on the reargument, to the Commission-

(2) See *infra hereto*, p. 25.

er's express allegations and admissions that this was a single exchange and the Tax Court's finding to the same effect, the majority, in its revised opinion, ignored the Tax Court's finding to the effect that the exchange was a single transaction, and omitted the reference which it had made at the end of its first opinion to this Court's statement in the *Dobson* case[3] that "whether an apparently integrated transaction shall be broken up into several separate steps" is a question of fact on which the Tax Court's finding is controlling.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that a recapitalization, planned and duly consummated for bona fide purposes other than tax avoidance, was not within the provisions of Sections 112 (b) (3) and 112 (g) of the Revenue Act because not undertaken for the benefit of the corporation as distinguished from that of the stockholders.

2. In supporting the Tax Court in its construction of this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465 as so stating the law.

3. In holding that the plan in question was not adopted and carried out pursuant to a "legitimate corporate business purpose."

4. In ignoring the Tax Court's finding of fact that the recapitalization under review consisted of a unitary exchange of old stock for new stock *and* debenture bonds, and holding that it consisted of an initial exchange of old stock for new stock *followed by* a distribution of the debentures, which constituted a taxable dividend, whereas, assuming that this was not a tax free "reorganization" under Section 112, the gain resulting under Section 112 (b) (2), (c) (1), was a capital gain, taxable under Section 117.

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(3) *Dobson v. Commissioner*, 320 U. S. 489, 502.

SUMMARY OF ARGUMENT.

I. The Transaction in Question Was a Recapitalization From Which, Under Sections 112 (b) (3) and 112 (g) No Taxable Gain Was Recognized.

Both the Tax Court and the Court below recognize that the exchange of all the outstanding stock of a corporation for its new stock *and* bonds constitutes a technical recapitalization and thus a reorganization under Section 112 of the Internal Revenue Code. *Helvering v. Watts*, 296 U. S. 387.

Gregory v. Helvering, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders*. What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

This Court did not, as the majority of the Tax Court and of the Court below would apparently have it appear, speak of a "corporate business purpose." This Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and unsupported by any other court except the majority of the Court below. The fact that the change in capitalization is adopted by the stockholders for *reasons other than tax avoidance* renders the *Gregory* case inapplicable.

In none of the later decisions by this Court has the *Gregory* decision been interpreted or extended as the Tax Court and the Court below would have it appear. In all of them the decision was understood merely to prescribe the disregarding of sham corporations formed and used for the sole purpose of tax avoidance.

The Tax Court expressly found four features in which the recapitalization was for the benefit of the stockholders in connection with matters having no relation to tax avoidance. The minority also found a benefit to the corporation in reducing its annual taxable income by the annual interest charge on the bonds. Furthermore, the recapitalization benefited the corporation by reducing the unit value of the shares so as to make it possible for the stockholders to sell a portion of such shares to employees, even though they had no intention of immediately doing so.

II. If the Exchange Is Not Viewed as a Reorganization Non-Taxable Under Section 112 (b) (3), It Is Nevertheless an Exchange Under Section 112 and by Section 112 (b) (2) and Section 112 (c) (1) Is Taxable Under Section 117.

Admittedly the new stock and bonds were received *in exchange for* the old stock. In view of this, it is impossible to split up the transaction and treat the issue of the bonds as a taxable dividend issued to petitioner by reason of his *ownership* of the old stock, and not in *exchange* for part of it.

No tax liability was impending against petitioner or the corporation. He realized no actual or present gain on receipt of the debentures. If, as and when they are sold by him or redeemed or paid off at maturity he will be subject to tax at the capital gains rate, just as he would be if he had sold that part of his stock which was exchanged for them. He has escaped no tax and will escape none which he should properly pay. Continuity of control was not affected, in the slightest degree, by the recapitalization.

The transaction, being an exchange, clearly comes under Section 112. If, as the Tax Court holds, the absence of legitimate corporate business purpose prevents it from being a reorganization and hence from coming under Section 112 (b) (3), it is nevertheless clearly within 112 (b) (2), and 112 (c) (1), being an exchange of common stock for common stock plus "other property"—debentures—constituting taxable gain. This "other property," having been received in the exchange and his original stock having been held for more than 24 months, under Section 111 the gain realized, to the extent recognized by 112 (b) (2) and 112 (c) (1) is taxable at the capital gains rate provided by Section 117. Since by hypothesis the exchange is not in a reorganization, Section 112 (c) (2) is by its terms inapplicable. Under the decision of this Court in *Commissioner v. Bedford*, 325 U. S. 283, a transaction which comes within Section 112 cannot be taken out of the requirements of Section 112 and forced into the mould of Section 115 as a taxable dividend. While in that case, since the exchange was in a reorganization under 112 (b) (3) and 112 (g), the extra cash was taxable as a dividend under Section 112 (c) (2); in the case at bar, if it be not a reorganization under Section 112 (b) (3) it comes under Section 112 (b) (2) and 112 (c) (1), and the gain represented by the debentures is taxable as capital gain under Section 117.

Argument.

I. THE TRANSACTION WAS A RECAPITALIZATION FROM WHICH UNDER SECTIONS 112 (b) (3) AND 112 (g) NO TAXABLE GAIN OR LOSS WAS RECOGNIZED.

Sec. 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Sec. 112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

In Order to Qualify as a Reorganization Under the Rule of the Gregory Case, a Recapitalization Need Not Have Been Effected to Benefit the Corporation.

The corporate proceedings here involved obviously constituted a "recapitalization." The Tax Court said of it (R. p. 96a):

> "Looking only at the language of the reorganization section, there was a technical recapitalization: that is, a reorganization within the statutory definition of section 112 (g) (1) (D). *Annis Furs, Inc.*, 2 T. C. 1096; *Clarence J. Schoo*, 47 B. T. A. 459, appeal dismissed (C. C. A., 1st Cir.). And since there was an exchange of stock for stock and securities in the same corporation, the language of the section forbids recognition of gain or loss. Section 112 (b) (3)."

In *Helvering v. Southwest Consolidated Corporation*, 315 U. S. 194, this Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

That an exchange of all the outstanding stock of the corporation for its new stock *and* bonds constitutes a "recapitalization" and hence a "reorganization" under Section 112 has been held by this Court as well as by the Circuit Courts and the Tax Court.[1]

A majority of the Court below, however, sustained the majority of the Tax Court in holding that under *Gregory v. Helvering*, 293 U. S. 465, in order to qualify a recapitalization as tax free under 112 (b) (3) it must appear that it had as its objective what the Tax Court terms a "legitimate corporate business purpose," constituting a benefit to the corporation as distinguished from a benefit to the stockholders.

But *Gregory v. Helvering*, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders*. What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not

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(1) *Helvering v. Watts*, 296 U. S. 387 (1935) (Serial Mortgage Bonds).
Commissioner v. Kolb, 100 F. (2d) 920 (1938) (10 Yr. Debenture Bonds).
South Atlantic Steamship Line, 42 B. T. A. 705 (1940) (25 Yr. Deb. Bonds).
Clarence J. Schoo, 47 B. T. A. 459 (1942) (25 Yr. Debenture Bonds).
Redford Lumber Co. (Memo op. Docket #106560, C. C. H. Dec. 12,865-B) (Debenture Notes).

See also:
Burnham v. Commissioner, 86 F. (2d) 776 (1936); cert. den. 300 U. S. 683 (1937) (Unsecured 10 Year Notes).
Commissioner v. Neustadt, 131 F. (2d) 528 (1942) (20 Yr. Debenture Bonds).
Karl B. Segall, 38 B. T. A. 43 (Debenture Notes).

contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

Nor did this Court there speak, as the Tax Court and the majority of the Court below would apparently have it appear, of a "corporate business purpose." This Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The distinction is between a sham reorganization where a corporation is formed for the sole and direct purpose of insulating a stockholder or a corporation from an impending tax, and genuine reorganizations having an objective other than tax avoidance, the result of which may be to reduce future taxes. As Justice Black said in the recent decision in *Court Holding Company v. Commissioner*, 324 U. S. 331, 334, "formalisms which exist solely to alter tax liabilities" cannot be availed of for that purpose.

In the argument of the case at bar in the Circuit Court of Appeals, respondent specifically admitted that the recapitalization was real and not a sham. On page 28 of their brief in the Court below respondent said:

> "*It is not disputed that the new common stock and debentures issued in the recapitalization were real and gave the recipients the rights in the Corporation which they purported to do, as taxpayer argues.* (Br. 36.) But the question here is whether what was done was inspired by purposes having a substantial relation to the Corporation's business, so that the recapitalization may be given effect for tax purposes." (Emphasis supplied.)

The essential facts of the *Gregory* case, in which this Court affirmed the decision of the Circuit Court of Appeals for the Second Circuit reversing the Board of Tax Appeals, are succinctly stated at the beginning of this Court's opinion (emphasis supplied):

"Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. *For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit*, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a 'reorganization' under section 112 (g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation as capital net gain the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction." (p. 467)

It will be noted that the *Gregory* case was not a recapitalization in which the security holders merely desired to "reshuffle" the "capital structure within the framework" of the corporation. It was in its essence and ultimate analysis a sale by the sole stockholder of corporate assets which the stockholder did not wish to receive as a dividend, but sought to effect through a dummy corporation formed and used for the sole purpose of minimizing the stockholder's

taxes and whose only function was to acquire such assets in order that it might be promptly dissolved and give them to the stockholder for sale by her.

After quoting the applicable provisions of the Act of 1928, this Court held (emphasis supplied):

"It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that *if a reorganization in reality was effected* within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham*, 17 Wall. 496, 506; *Superior Oil Co. v. Mississippi*, 280 U. S. 390, 395-6; *Jones v. Helvering*, 63 App. D. C. 204; 71 F. (2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

"When subdivision (B) *speaks of a transfer of assets by one corporation to another, it means a transfer made* 'in pursuance of a plan of reorganization' (Section 112 (g)) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation *having no business or corporate purpose* a mere device which put on the form of a corporate

reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of *corporate shares* to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

"In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance *masquerading as a corporate reorganization*, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." (pp. 468-470)

The *Gregory* case clearly holds that, where a reorganization involves a transfer of property from one corporation to another, in order to come within the statutory definition of "reorganization" the transaction must pertain to the legitimate corporate purpose of the acting companies or one of them. It does not, however, hold (as the Court below and the Tax Court hold in this case at bar) that a "recapitalization" does not come within Section 112 (b) (3) and 112 (g) unless it affirmatively appears that it was planned and carried out to accomplish a "legitimate corporate business purpose" of the corporation which is re-

capitalized, as distinguished from a bona fide purpose of its stockholders.

The foregoing construction of the *Gregory* decision is confirmed by Judge Hand's opinion in the Court below which this Court there affirmed. In holding that the transaction was a mere tax-avoiding sham and no part of the legitimate business of either corporation, Judge Hand said (69 F. (2d) 809, 811):

> "The purpose of the section is plain enough; *men engaged in enterprises*—industrial, commercial, financial, or any other—might wish to consolidate, or *divide*, to add to, or subtract from, *their* holdings. Such transactions were not to be considered as 'realizing' any profit, *because the collective interests still remained in solution*. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'" (Italics ours.)

Clearly in the first sentence Judge Hand was referring to the desire of the stockholders to "consolidate, or divide, to add to, or subtract from, their holdings" for their advantage, irrespective of any specific benefit to the corporation other than to have a capital structure advantageous to its stockholders.

The same conclusion follows from an examination of the later decisions by this Court construing and applying the *Gregory* case.[2]

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(2) See *Helvering v. Minnesota Tea Co.*, 296 U. S. 378, 385, where this Court said of the Gregory decision:—

> "*Gregory v. Helvering*, 293 U. S. 465, revealed a sham—a mere device intended to obscure the character of the transaction. We, of course, disregarded the mask and dealt with realities. The present record discloses no such situation; nothing suggests other than a bona fide business move.

See also:

Griffiths v. Commissioner, 308 U. S. 355, 357-8.

Origin of the "Corporate Business Purpose" Test.

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and is unsupported by any other court except the majority of the Court below.

During the years following *Gregory v. Helvering*, that decision was applied by the Tax Court solely to cases similar to that there involved,—where the sole owner of the stock of a corporation desired to secure for sale to a prospective purchaser a portion of the corporation's assets, and for the purpose of avoiding the surtax which would result from receiving such assets as a dividend, organized a "conduit" corporation through which the asset should be passed and the dummy corporation be dissolved or become moribund, the transaction having been motivated solely by a desire to avoid an impending tax on a dividend, the *conduit corporation* conducting no real business, and the whole transaction constituting what the Tax Court terms a "sham", masquerading in the guise of a reorganization.[4]

Where the Board considered that the transaction was a genuine one and not a sham, it held in these early cases that the *Gregory* principle was inapplicable.[5]

Electrical Securities Corp. v. Commissioner, 92 F. (2d) 593, 594-5 (C. C. A. 2d).
Commissioner v. Gilmore's Estate, 130 F. (2d) 791, 795-6 (C. C. A. 3d).
Morgan Mfg. Co. v. Commissioner, 124 F. (2d) 602, 605 (C. C. A. 4th).
Lyon v. Commissioner, 127 F. (2d) 210, 213 (C. C. A. 6th).
Commissioner v. John Thomas Smith, 126 F. (2d) 556, 559 (C. C. A. 2d).
Commissioner v. Capento Sec. Corp., 140 F. (2d) 382, 385 (C. C. A. 1st).
National Investors Corp. v. Hoey, 144 F. (2d) 466, 468 (C. C. A. 2d).
Tyson v. Commissioner, 146 F. (2d) 50, 5[illegible] (C. C. A. 8th).

(4) See *Royal Marchant*, 32 B. T. A. 76; *Handbird Holding Corp.*, 32 Id. 238; *Penn's Investment Co., Ltd.*, 33 Id. 30; *Flinders Investment Co.*, 33 Id. 483; *Thomas N. Perkins*, 33 Id. 606; *Robert R. McCormick, Exec.*, 33 Id. 1046; *Harold B. Franklin*, 34 Id. 927; *Electrical Securities Corp.*, 34 Id. 988; *Arthur S. Kleeman*, 35 Id. 17; *Helen Sperry Lea*, 35 Id. 243; *Philip J. Cogan*, 36 Id. 639; *A. W. Mellon*, 36 Id. 977; *George D. Graham*, 37 Id. 623; *Estate of Walter C. Bailey*, 37 Id. 647; *W. & K. Holding Corp.*, 38 Id. 830; *Belle G. Loewenberg*, 39 Id. 844; *Sam Pickard*, 40 Id. 258; *Robert M. Morgan*, 41 Id. 370.

(5) *Claude Neon Lights, Inc.*, 35 B. T. A. 424; *General Motors Corp.*, 35 Id. 523; *James Lee Johnson*, 37 Id. 155.

In a number of cases the Board of Tax Appeals and the Tax Court has sustained recapitalizations which were clearly for the sole benefit of the stockholders, as distinguished from the independent corporate benefit, the distinction, later invented, not being discussed. These cases are collected in Addendum B to this brief *infra*, pp. 53-65.

Other recapitalizations, which were not claimed to have benefited the corporation as distinguished from the stockholders, have similarly been sustained by the Circuit Courts.[6]

The supposed necessity for a *corporate* business purpose as distinguished from a *stockholders'* objective, unrelated to tax avoidance, is a recent invention by the Tax Court, having been first definitely suggested in a dictum by Judge Harron in the case of *Humko Co.*,[7] decided by her in December, 1943, almost nine years after the *Gregory* decision. This test was applied by the Tax Court for the first time in the case at bar and in the companion case of *Adams*, 4 T. C. 1186; 5 T. C. 351.

The Basic Unsoundness of the Tax Court's Test.

It is a fundamental principle of corporation law that all activities within the scope of the corporate charter,—whatever the corporation may properly do for its corporate benefit, in the furtherance of its business,—are to be carried on by its board of directors. Stockholder action is required and appropriate only in connection with matters which concern the relation of the stockholders among themselves,—which modify the agreement among them incident to their formation of the corporation, with which matters the corporation itself is not directly concerned. Thus, the

(6) See
Commissioner v. Kolb, 100 F. (2d) 920, 926 (9th Circuit);
Skenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (2d Circuit);
Morainville v. Commissioner, 135 F. (2d) 201 (6th Circuit;
Knapp Monarch Co. v. Commissioner, 139 F. (2d) 863 (8th Circuit).

(7) Docket 112235, 79, unreported, but see C. C. H. T. C. Service, Dec. 13,642 (M). See *infra* Addendum B at p. 61 thereof.

directors alone may properly authorize the making of contracts. Under the laws of no State, however, may the directors change the capitalization by authorizing stock not provided for in the charter, or by altering the rights of the stockholders inter sese. These matters are for the *stockholders* and are a part of *their* business, not a part of the corporation's business.

The reorganization provisions of the Revenue Act are not confined, however, to matters within the scope of the corporation's business,—matters which may be regulated by the directors; see Sec. 112 (b) (3), 112 (g) (1). These provisions apply to the stockholders as well as to the corporation. Indeed, the provisions relative to recapitalization concern the stockholders primarily, if not exclusively. Neither the Tax Court nor respondent nor the majority of the Court below have suggested any reason why, as to recapitalizations, a "business purpose" test should apply only to the corporation and should not apply to the stockholders, whose action as such is necessary to bring it about. Nor have they explained how there can conceivably be a "corporate business purpose" in connection with something which may be no part of the corporation's business and which, through its board of directors, charged with regulating its business, it has no power to regulate.

The Tax Court Has Invented a Test so Vague as to be Practically Unworkable.

The disregard by the majority of the Tax Court and by the majority of the Court below of the fundamental principle above summarized would, if followed, introduce into the administration of Section 112 of the Revenue Act a test so vague and variable as to introduce lamentable uncertainty into the administration of the law. As the dissenting opinion of Judges Maris and Goodrich clearly demonstrates, what is for the benefit of the corporation, as distinct from that of the stockholders, and vice versa, is something on which no two lawyers, no two accountants or

no two business men could agree. To inject such a test as that proposed by the Tax Court into the administration of the law would render the soundness of a recapitalization under Section 112 dependent principally on the whim of the Revenue Agent, the Commissioner, or the Judge who passed on the case. It would also throw doubt on a great number of completed recapitalizations about which no previous doubt existed. For example, there have been and will doubtless be innumerable instances of recapitalizations, of corporations a majority or all of the entire capital stock of which is owned by a holding company which, for reasons of its own, desires to have the securities of a subsidiary in a different form,—stock for stock, bonds for stock, preferred of a different type, etc. There has never been any suggestiton that these recapitalizations are not tax free, although it is inconceivable that there could be any purpose except that of the holding company whose wishes the subsidiary is bound to carry out.

In the great majority of cases involving recapitalizations, the changes in the capital structure of a corporation are in reality advantageous only to the stockholders. For example, is there a demonstrable corporate advantage in the exchange of $100,000. par value 4% preferred stock and $100,000. par value of common stock for $80,000. par value 5% preferred and 1250 shares of no par common? What corporate advantage is there in the substitution of preferred stock for common stock, or in the recapitalization noted at the end of the dissenting opinion, where common stockholders arranged for a reclassification of part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control? If the rule here established be followed, it will set up a test of the validity of scores of recapitalizations so vague as to be wholly unpredictable, resulting in conclusions based on no substantial differences, in cases, all of which result in no change of continuity in control and in no present realization of actual gain to the stockholders, but merely

in a change in the form of the security. Such a radical departure from long existing practice and legal standards should, it is submitted, be effected, if intended, only by a prospective amendment to the law by Congress.

The Corporate Benefit Test Is Contrary to the Commissioner's Regulations.

The majority opinion by the Court below, sustaining the Commissioner's contention said (R. p. 135) that the Tax Court's "corporate benefit" test was pursuant to the Regulations by the Commissioner in effect since 1[illegible]. Such, however, is not the case; quite the contrary. The Regulation, interpreting the *Gregory* decision, merely provides that corporate readjustments, in order to qualify as reorganizations must be such "as are required by business exigencies." This clearly meant, as distinguished from a sham purpose by the stockholders to avoid tax. Where the Regulation provided that such reorganizations must be "undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization" it obviously intended merely to exclude a dummy corporation, formed solely to avoid taxes, having no business and dissolved immediately its purpose was accomplished.

That the Regulation was not intended and was never interpreted as laying down a "corporate business" test for recapitalization is conclusively demonstrated by Regulations 103, Sec. 19.112 (g)-2 (*infra* p. 43-44 hereof), where in describing what constitutes a "recapitalization" under the reorganization provisions of the law the Commissioner gives four examples (omitted in the extract from the Regulations annexed to respondent's brief in the Court below) of what constitutes such statutory "recapitalization". Nowhere is it stated in the Regulation that these changes in capitalization must, in order to qualify as a recapitalization, be prompted by a corporate as distinguished from a stockholder's purpose. The third example of a recapitalization qualifying as tax-free is (*infra*, p. 43):

"(3) a corporation issues preferred stock previously authorized but unissued for outstanding common stock."

It is, we submit, impossible to find or imagine any benefit to the corporation, as such, by the substitution of preferred for common stock. The sole benefit would be to those common stockholders who received preferred stock for their common. Neither the majority of the Tax Court nor that of the Court below explain or even refer to this Regulation, although we quoted it in our brief below and emphasized it particularly in the oral argument.

The Dissenting Opinion.

The dissenting opinion by Judges Maris and Goodrich contains so clear and concise an analysis of the legal principles which these two judges apply to the Tax Court's findings of fact, that we find it impossible to summarize or abstract it. Accordingly, we refer to it, as printed on pages 137-140 of the Record, for a clear exposition of the fallacy of the Tax Court's "corporate business purpose" theory.

The Tax Saving Deduction on Account of the Interest on the Bonds.

The benefit to the corporation by the saving of taxes resulting from the interest charge on the bonds was ignored by the majority of the Tax Court, although discussed by the minority. This point is directly presented and fully covered in the *Adams* case, which is to be argued at the same time as the case at bar, hence we do not deem it necessary to discuss it at length.

II. IF THE EXCHANGE IS NOT VIEWED AS A REORGANIZATION NON-TAXABLE UNDER SECTION 112 (b) (3), IT IS NEVERTHELESS AN EXCHANGE UNDER SECTION 112 AND BY SECTION 112 (b) (2) AND SECTION 112 (c) (1) IS TAXABLE UNDER SECTION 117.

Petitioner Did Not and Will Not, by Means of the Recapitalization, Escape Any Tax to Which, But for It, He Would Have Been Subjected.

In the Tax Court's opinion it was intimated (see R. p. 102a) that the individual stockholders may have had it in mind so to arrange that on redemption of the bonds they would be taxable on their proceeds only at the capital gains rate.

Admittedly there was no tax liability impending against either the corporation or its shareholders at the time the Plan of Reorganization was planned, adopted, or put into effect.

This Court has frequently emphasized the right of a taxpayer properly to minimize his taxes.[8]

If the stockholders had merely desired to realize $400,000, at the same time retaining their common stock, but be liable for tax on that amount only at the capital gains rate, there were several other ways that they could have accomplished this.

They could have had declared a stock dividend of $400,000 payable to the common stockholders in preferred stock and subsequently sold the preferred stock. There would have been no tax on account of the stock dividend[9] and on the sale of the preferred stock they would have been liable to tax only at the capital gains rate.

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(8) *Gregory v. Helvering*, 293 U. S. 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham*, 17 Wall. 496, 506, 21 L. Ed. 728."

(9) *Commissioner v. Sprouse*, 318 U. S. 604.

Similarly, they could have liquidated the company, in which case they would have paid capital gains tax on the difference between their investment basis and their realization from the liquidation. Afterward they could have formed a new company and turned over to it the entire assets realized from the liquidation in exchange for 500,000 shares of no par stock, and $400,000 bonds, in which case they would have been liable for no further tax on the redemption or payment of the bonds at maturity.

The stockholders have not evaded or avoided any tax liability to which they were subject. As said by the Court below in *Commissioner v. Gilmore*, 130 F. (2d) 791 at page 795, the law does not require a taxpayer to avail himself of the method of attaining a given result which will subject him to the most taxes.

The Court Below Disregarded the Essential Primary Finding by the Tax Court That the Transaction Was a Unitary Exchange of Old Stock for New Stock and Bonds.

Assuming, for the purpose of the present argument, that the recapitalization was not tax free because not demonstrably for the benefit of the corporation, the Tax Court had squarely presented to it the problem of deciding, as a matter of fact, whether the transaction was

(1) a single transaction,—a unitary exchange of the 1,000 old $100 par shares for 5,000 new no par shares *and* $400,000 debenture bonds; or,

(2) an exchange of the old stock for the new stock, *followed by* a distribution of the bonds as a dividend.

This Court said, in *Dobson v. Commissioner*, 320 U. S. 489 at page 502:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary

determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

It was accordingly incumbent on the Tax Court to find specifically whether this was an *exchange* of the old common stock for the new common stock *and* the debenture bonds, or to find, as it did in *Edith B. Bass*, 45 B. T. A. 1117, 1120-21 (see also 129 F. (2d) 300) that the delivery of the bonds was an independent distribution and not part of the unitary exchange.

The Tax Court found that the transaction in question was an **exchange** of the old common stock for the new common stock **and** the debenture bonds.[11] In describing the plan of reorganization, it said:

> "The corporation was to issue **in exchange for the old stock**, the new stock **and** the debenture bonds . . ." (R. pp. 92a-93a.)
>
> "**Pursuant to the plan**, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in the aggregate principal amount of $400,000." (R. 93a-94a.) (Emphasis supplied.)

At the end of the first paragraph of its opinion the Tax Court again characterizes the transaction as "**an exchange of stock for stock and securities** of the same corporation" (R. p. 96a.)

The Tax Court at the beginning of its formal Findings of Fact (R. 90a), found the facts in the stipulation including paragraphs 10, 12 and 18, which (R. 16a-18a) stated that

(11) In *Flanagan v. Helvering*, 116 F. (2d) 937, cited by the Court below, there was admittedly a redemption of part of the corporation's stock, which the Tax Court held not to have been a partial liquidation but essentially equivalent to the distribution of a taxable dividend taxable as such under Sec. 115 (g).

the shares of new common stock and the debenture bonds were issued by the company **in exchange** for the shares of $100 par stock previously outstanding.

Under the record admissions and allegations by the Commissioner in this case, the Tax Court could not have found otherwise.

In his income tax return for 1939 petitioner had returned no gain from the receipt of the new stock and bonds in the recapitalization; taking the position that, under Section 112 (b) (3) and 112 (g) of the Act, no gain or loss was properly recognizable therefrom.

The Commissioner, however, increased petitioner's taxable income by $319,200, explaining such increase in the deficiency notice (R. 17a) as follows:

> "'(a) Other income has been increased $319,200 representing the fair market value of bonds of J. Robert Bazley, Inc., **received in exchange of common stock of that corporation.**'" (Emphasis supplied.)

In his petition to the Tax Court contesting the additional assessment based on the above, petitioner alleged, under paragraph V (5) and (6) (R. pp. 5a-6a):

> "(5) **Pursuant to the Plan** of Reorganization and Recapitalization, **the corporation exchanged** the 5000 shares of new common stock without par value **and** $400,000. of principal amount of debenture bonds for the 1000 shares of common stock outstanding. **The exchange** was made on the basis of 5 shares of new common stock without par value **and** $400. of debenture bonds for each share of old common stock outstanding. The 1000 shares of old common stock were then cancelled on the books of the corporation.
>
> "(6) The Petitioner in April, 1939, **pursuant to and in accordance with the terms of the Plan** of Reorganization and Recapitalization **received in exchange** for his 798 shares of $100. par value common stock of

J. Robert Bazley, Inc., 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture bonds of the same corporation. • • •

• • • • • • •

"In the further alternative, if it be held that Petitioner realized taxable income or gain in 1939 as a result of the foregoing exchange, then Petitioner contends that the Commissioner erred in determining that such income or gain was ordinary income instead of capital gain as provided by Section 117 of the Internal Revenue Code." (Emphasis supplied.)

In the Commissioner's answer to the above paragraphs of the petition, he alleged:

"(5) Admits that said corporation **exchanged** 5,000 shares of new common stock without par value **and** $400,000.00 of principal amount of debenture bonds for the 1,000 shares of old common stock outstanding; admits that the **exchange** was made on the basis of 5 shares of new common stock without par value **and** $400.00 of debenture bonds for each share of old common stock; admits that the 1,000 shares of old common stock were then cancelled; denies the remaining allegations of paragraph V (5) of the petition.

"(6) Admits that in April, 1939, petitioner **received in exchange** for his 798 shares of $100.00 par value old common stock of J. Robert Bazley, Inc., 3,990 shares of no par new common stock of said corporation **and** $319,200.00 principal amount of 20-year 6% debenture bonds of said corporation; denies the remaining allegations of the first sentence of paragraph V (6) of the petition; • • • denies the remaining allegations and opposes the remaining contentions made by petitioner in said paragraph V (6) of the petition." (R. pp. 12a-13a.) (Emphasis supplied.)

If the Tax Court, disregarding the stipulation and respondent's admissions, had found that the transaction **did not in fact** consist of an exchange of the old stock for new stock **and** bonds, but in fact consisted of an exchange of the old stock for the new stock, and that the "distribution" of the bonds was in fact a separate transaction and not part of the exchange, this would be a different case. The Tax Court, however, did not so find, but found that the issuance of the bonds was part of the unitary transaction which constituted the exchange.

In disregard of this Court's admonition in the *Dobson* Case, and in spite of the express admissions by the Commissioner on which were based the findings of the Tax Court above quoted, the majority of the Court below, as clearly shown by the last paragraph of its original opinion (R. p. 116), treated the transaction as one involving an exchange of the old stock for the new stock "followed by a distribution of the 20 year debenture bonds."

Under the rule of *Dobson v. Commissioner*, it is not the function of the Circuit Courts to alter the primary findings of fact by the Tax Court in order to sustain its legal conclusions, any more than to reverse them.

Under *Bingham's Trust v. Commissioner*, 325 U. S. 365, it is both the function and duty of the Federal Appellate Courts to correct the Tax Court's erroneous application of the law **to the facts found by that Court.**

Under the finding by the Tax Court that this was a unitary exchange, we have the simple case of an exchange of property, the old stock, which had been held by the taxpayer for 9 years, for new stock **and** bonds.

In the Tax Court's opinion it is stated (R. p. 96a) that "*since there was an exchange* of stock for stock and securities in the same corporation, the language of the section forbids recognition of gain or loss." (Emphasis supplied.)

In view of the foregoing how can it now be contended that, irrespective of whether or not the transaction was a tax free reorganization, the issue of the bonds, together

with stock, was not in *exchange* for the stock but was "essentially equivalent to the distribution of a taxable dividend" *on the stock* under Section 115 (g)?

Admittedly the old stock was not "redeemed" by the corporation. It was doubtless for this reason,—recognizing that Section 115 (g) was not designed to cover and does not cover cases involving a recapitalization of a corporation's entire capital structure in a reorganization,—that the Commissioner, in his brief in the Court below (p. 30) repudiated the Tax Court's legal conclusion that this case came under subdivision (g) of that Section, and relied on subdivision (a) of that Section, despite the Commissioner's admission and Tax Court's express finding that the debenture bonds were issued with the new stock, in exchange for the old stock.

There being a unitary exchange of old common stock for new common stock and debentures—all the cases are clear that the transaction may not be broken into one exchange plus a distribution, or into two exchanges.

Dobson v. Commissioner, 320 U. S. 489, 502;
Helvering v. Minnesota Tea Co., 89 F. (2d) 711 (1937); affd. 302 U. S. 609;
Starr v. Commissioner, 82 F. (2d) 964 (1936); cert. den. 298 U. S. 680;
Ahles Realty Corp. v. Commissioner, 71 F. (2d) 150 (1934); cert. den. 293 U. S. 611;
Prairie Oil & Gas Co. v. Motter, 66 F. (2d) 309 (1933);
Shenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (cert. den. 314 U. S. 696);
South Atlantic S. S. Co. v. Commissioner, 42 B. T. A. 705;
Globe-News Co. v. Commissioner, 3 T. C. 1199;
Clayton and Hooks v. Commissioner, Memo. Dec. Docket Nos. 109416, 109427, entered August 22, 1944, C. C. H. Dec. #14111 (M).

In view of the apparent misunderstanding by the Court below, not only of the Tax Court's findings of fact, but of the scope of these complex provisions of the statute, a brief further analysis of the provisions of the law relative to the sale and exchange of property will, we believe, be helpful to the Court.

Upon *every sale of property* for cash *and upon every exchange of property for other property*, the Code, by Sec. 111,[12] first requires that there shall be made *a determination* of the total amount of the gain or loss therefrom; irrespective of the extent to which such gain may or may not be taxable. This is also true regardless of the fact that the exchange is or is not in connection with a "reorganization", as such term is used in Sec. 112. Sec. 111 therefore prescribes that in computing such gain or loss there shall be subtracted from the value of all property received the cost basis of the property given up in the exchange.

Accordingly, since in this **admitted exchange** the taxpayer exchanged his 798 shares of $100 par stock, having a cost basis of $79,800, for new no par common stock (3,990 shares) valued at $239,400. and new debenture bonds valued at $319,200, Sec. 111 (a) and (b) requires the gain to be computed as follows:

Value of new bonds	$319,200
Value of new stock	239,400
Total value realized from exchange	$558,600
Minus cost basis of $100 par stock	79,800
Total gain determined	$478,800

However, Sec. 111 (c) states *that the extent to which* **such gain** *shall be "recognized" for the purposes of income tax* must be determined by Sec. 112.

(12) See the various Sections of the Code hereafter referred to, as well as the Regulations in Addendum A hereto.

This latter section, by the general rule set forth in Sec. 112 (a), requires that the entire amount of such gain shall be recognized EXCEPT as further provided in the additional sub-divisions, Sec. 112 (b)-(g) inclusive.

The two *exceptions* to this general rule which, we submit, apply to the instant case (assuming the non-recognition of gain exception in (b) (3) not to apply) are Sec. 112 (b) (2) and Sec. 112 (c) (1).

The *first* applicable *exception*, namely, Sec. 112 (b) (2) prescribes that upon an exchange of common stock for common stock *no gain shall be recognized* and this exception is carried over into Sec. 112 (c) (1) which contains the *second exception.* This latter exception prescribes that where, upon such an exchange, there is received (in addition to common stock) other property, *then the gain so determined by Sec. 111* **shall be recognized** only in an amount which is not in excess of the fair market value of such "other property". This result is expressly and clearly borne out by the interpretative Treasury Regulations, Sec. 19.112 (b) (2)-1 and Sec. 19.112 (c)-1 (See Add. A pp. 44 and 46).

This latter Treasury Regulation (Sec. 19.112 (c)-1) specifically states that if *in any transaction* in which common stock is exchanged for common stock, *and not in connection with a corporate reorganization,* there is received by the taxpayer other property (in addition to property admitted to be received without recognition of gain) then the gain, if any, to the taxpayer will be recognized in an amount not in excess of the fair market value of the "other property".

Therefore, if this Court should hold that taxpayer's admitted "exchange" did not constitute a reorganization within the non-recognition gain exception of Sec. 112 (b) (3), it is quite clear that the *exceptions* of Sec. 112 (b) (2) and (c) (1) must be applied so that only that part of the gain is recognized which represents the value of the "other property", namely, the bonds (valued at $319,200) received in the exchange by taxpayer.

The next statutory step required is to ascertain the extent to which the "recognized gain", if any, shall be taken into account as capital net gain, and is to be found in Code Sec. 117 (b) which prescribes that where the capital asset has been held for more than 24 months then 50 percentum of such "recognized gain" shall be taken into account. Consequently, since Bazley, the taxpayer, held his old $100 par stock for more than 24 months, having acquired the same in May, 1930, Stip. par. 12, R. 17a, when the corporation was organized, only 50 percentum of the recognized gain upon the admitted "exchange" or $159,600. must be taken into account in computing his taxable capital gain.

The last statutory step is to ascertain the amount of tax to be imposed upon the taxable gain. This is prescribed by Sec. 117 (c) "Alternative Taxes".—(1) to the effect that the tax on such capital gain shall not exceed 30 percentum of that part of the gain to be taken into account or $47,880.

The Tax Court and the Court below held that this transaction did not constitute a reorganization within Section 112 (b) (3) because it lacked a legitimate corporate business purpose, but failed to realize that even assuming such purposes to have been lacking, nevertheless, it was an exchange under the express provisions of Section 111 and 112 because the courts say the transaction must be looked at as a whole.[13] Therefore, the transaction falls within Section 112 (b) (2) for the reason that there was an exchange of par value common for no par value common. However, as bonds were a part of the consideration given with the no par common the bonds, unlike "securities" under the provisions in a 112 (b) (3) reorganization, constitute "other property" and, therefore, come within Section 112 (c) (1) [14] which provides, in effect, that gain or

(13) See cases cited p. 20, *supra*.

(14) Section 112 (c) (1):

"(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

loss shall be recognized to the extent of the fair market value of such "other property."

Our dispute with the decision of the Tax Court is not a dispute over proper accounting, but a challenge of the correctness of that Court's conclusion of law that, despite its express finding that this was an exchange of stock for stock *and* bonds, pursuant to respondent's clear admission and agreement that such was the case, the Tax Court concludes *as a matter of law* that the issuance of the bonds was a dividend, separate from and prior or subsequent to the exchange, of which it had previously found that it was an integral part.

In *Commissioner v. Estate of Bedford*, 325 U. S. 283, decided May 21, 1945, the Court said that a transaction which was properly an exchange under Section 112 could not be taken out of the requirements of that Section and forced into the mould of Section 115. That case involved the exchange of stock for stock and cash under what the Court held was a reorganization and which accordingly came directly within Section 112 (c) (2) [15] and since the cash represented earnings after 1913 it was taxable under that section as a dividend and not, as the taxpayer contended, as a partial liquidation under Section 115.

In the case at bar the exchange comes under 112, but being, *by hypothesis, not a reorganization*, does not come under 112 (c) (2), which is confined to reorganizations, but comes under 112 (c) (1) which applies to cases in which a transaction would be under 112 **(b)** (2) but for the other property—an exchange for stock plus some property other than stock, i. e., the debentures.

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(15) Section 112 (c) (2):

"(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

Gains realized by the exchange of capital assets as determined under Section 111 and recognized under 112 (c) (1) are therefore taxed under Section 117 relating to gains in the exchange of capital assets.

Accordingly, the gain represented by the value of the bonds would be taxable at the capital gains rate.

CONCLUSION.

The question as to whether this Court's opinion in the *Gregory* case requires a recapitalization to be for the benefit of the corporation as distinguished from the stockholders is clearly a question of law in which the Tax Court's conclusion is reviewable on appeal.

The exchange of the old $100 par stock for new no par stock and debentures was a recapitalization of the Bazley Corporation, and since debentures are securities within the meaning of Section 112 (b) (3), the exchange comes precisely within the terms of that provision.

The transaction was in no sense a sham, but was a genuine recapitalization. This genuineness is in no way impaired by the fact that reasons which the Tax Court found as actuating the recapitalization were for the primary benefit of the stockholders, as distinguished from that of the corporation itself. Furthermore, the recapitalization was a benefit to the corporation in that it rendered the corporation's stock more readily marketable, and effected an annual tax saving to it by reason of the future deduction from income of the annual interest on the debentures.

The continuity of interest on the part of the stockholders was not to the slightest degree impaired by the recapitalization. After it the three stockholders remained in the ownership and control of the corporation in precisely the proportions which they did before.

Petitioner did not, by means of the recapitalization, escape any tax impending against him or any to which he should properly be subjected in the future. He could have received a stock dividend in preferred stock and have

sold it, or could have liquidated the company and received all its assets, subject to payment of capital gains tax on the gain realized thereby over the cost of his stock. If, when and as his debentures are sold or redeemed, he will pay capital gains tax on the gain represented by them.

If, by reason of the absence of a legitimate corporate business purpose, the transaction is not a reorganization under Section 112 (b) (3), it is certainly an exchange of stock for stock and "other property" (the debentures) under Section 112 (b) (2), in which case such "other property," being received in partial exchange for stock held for more than 24 months, is taxable under Sections 112 (c) (1) and 117. Under the decisions, the single transaction, being an exchange under Section 112, cannot be taken out of the requirements of that Section and forced into the mould of Section 115 (g) as a dividend. Accordingly, on the theory of the Tax Court that the exchange was not a reorganization, the gain represented by the value of the debentures would be taxable at the capital gains rate under Section 117.

It is respectfully submitted that the judgment of the Court below should be reversed and judgment entered for the petitioner.

Respectfully submitted,

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ADDENDUM A.

PERTINENT PROVISIONS OF THE INTERNAL REVENUE CODE AND THE TREASURY REGULATIONS.

(*Emphasis in bold-faced type supplied.*)

CHAPTER I. Income tax.

Subchapter B. General Provisions.

Part II. Computation of Net Income.

Subchapter C. Supplemental Provisions.

Supplement B. Computation of Net Income.

(Supplementary to Subchapter B, Part II).

CODE SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) **Computation of gain** or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) * * *.

(b) **Amount realized.**—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) **Recognition of gain** or loss.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112. * * *

REGULATION SEC. 19.111-1. **Computation of gain or loss.**—Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. * * * The general method of computing such gain or loss is prescribed by section 111, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 113 (b) * * *.

CODE SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) **General rule.**—Upon the sale or exchange of property the **entire** amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

REGULATION SEC. 19.112 (a)-1. **Sales or exchanges.** The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. **The general rule is that the entire amount of such gain or loss is to be recognized.**

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the

Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. **The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure,** and the new property **are substantially continuations of the old still unliquidated.**

The Internal Revenue Code makes specific provision for the case in which, in addition to property which may be received tax free on the exchange, there is received as boot other property or money. In such a case gain is recognized to the extent of the boot (see section 112 (c) and (d), but no loss of any kind is recognized (see section 112 (e)).

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. **Nonrecognition is accorded by the** Internal Revenue **Code only if the exchange is one which satisfies both** (1) **the specific description in the Code of an excepted exchange, and** (2) **the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand.** The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only. . . .

* * * * * *

CODE SEC. 112 (b). EXCHANGES SOLELY IN KIND.

(2) Stock for Stock of Same Corporation.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

REGULATION SEC. 19.112 (b) (2)-1. **Stock for stock of the same corporation.**—The exchange, without the recognition of gain or loss, of common stock for common stock, * * * in the same corporation is not limited to a transaction between a stockholder and the corporation; it includes an exchange between two individual stockholders. * * *

* * * * * * *

CODE SEC. 112 (b) (3). Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

CODE SEC. 112 (g). DEFINITION OF REORGANIZATION.—As used in this section and section 113.

"(1) the term 'reorganization' means * * * (E) a recapitalization," * * *

REGULATION SEC. 19.112 (g)-1. **Purpose and scope of exception of reorganization exchanges.**—Purpose: Under the general rule upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifica-

tions of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

Scope: The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112 (b) (3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112 (b) (4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112 (g) limits the definition of the term "reorganization" to six kinds of transactions and excludes all others. From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 112 (g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in sections 112 (c) and 112 (d). Under section 112 (i) a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

REGULATION SEC. 19.112 (g)-2. **Definition of terms.**—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). * * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) **A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or**

(4) An exchange is made of a corporation's outstanding preferred stock, having certain prior-

ities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interest under modified corporate forms.

As used in section 112, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received.

REGULATION SEC. 19.112 (g)-3. **Exchanges solely of stock or securities, or property, solely for**

stock or securities, in pursuance of plan of reorganization.—No taxable income is received, nor is a deductible loss sustained, if the shareholders in a corporation a party to the following reorganization transactions exchange stock or securities solely for stock or securities of the same corporation, or of another corporation mentioned, * * *:

(6) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (a) a recapitalization of a corporation, or (b) a mere change in the identity, form, or place of organization of a corporation, however effected.

REGULATION SEC. 19.112 (g)-4. **Exchanges in reorganization for stock or securities and other property or money.** If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)). * * *

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an

amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized. * * *

CODE SEC. 112 (c). GAIN FROM EXCHANGES NOT SOLELY IN KIND.

(1) If an exchange would be within the provisions of subsection (b) * * * (2) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, **to the recipient shall be recognized,** but **in an amount not in excess** of the sum of such money and the **fair market value of such other property.**

(2) If a distribution made in **pursuance of a plan of reorganization** is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

REGULATION SEC. 19.112 (c)-1. **Receipt of other property or money in tax-free exchange** *not connected with* **corporate reorganization.**—If in any transaction in which * * * (b) common stock is exchanged for common stock, * * * in the same cor-

poration **and not in connection with a corporate reorganization;** * * * there is received by the taxpayer other property (in addition to property permitted to be received without recognition of gain) or money, **then**

(1) **The gain, if any, to the taxpayer will be recognized in an amount not in excess** of the sum of the money and **the fair market value of the other property,** but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)). * * *

See section 113 (a) (6) for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this section.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see section 19.112 (g)-4.

CODE SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(c) Distributions in liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. * * *

(g) Redemption of stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

REGULATION SEC. 19.115-9. **Distribution in redemption or cancellation of stock taxable as a dividend.**—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

* * * * * *

(h) Effect on earnings and profits of distributions of stock.—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or an behalf of a corporation of its

stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act. * * *

REGULATION SEC. 19.115-11. **Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1) * * * or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution. * * *

CODE SEC. 117. CAPITAL GAINS AND LOSSES.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset

shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

REGULATION SEC. 19.117-2. **Percentage of capital gain or loss taken into account: Net loss carry-over.**—(a) General.—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held.

CODE SEC. 117 (c). ALTERNATIVE TAXES.

(1) In case of net long-term capital gain.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain. * * *

ADDENDUM B.

Analysis of Decisions by the Tax Court Subsequent to Gregory, and Sustaining Recapitalizations Which Were Primarily or Exclusively for the Benefit of the Stockholders.

Apparently the first case in which the Board was asked to apply the *Gregory* principle to a recapitalization, as distinguished from a corporate reorganization in connection with the sale or distribution of corporate assets, was *L. & E. Stirn, Inc.*, 39 B. T. A. 143 (January 19, 1939). Here the transaction consisted of the exchange by a stockholder who owned 4636 shares of preferred stock, constituting 55.08% of the outstanding preferred, for $463,600 debentures. There was apparently no evidence whatever as to the reason or motives for the recapitalization, nor any suggestion of any benefit to the corporation resulting therefrom, the sole benefit being clearly that to the stockholder, except that corporate taxes obviously would be reduced by the deduction of the bond interest. Despite this, the Board sustained the recapitalization as within the Act, saying (p. 146):

> "Here it [petitioner] cites *Gregory v. Helvering*, 293 U. S. 465, but we are unable to see the applicability of the situation. The transaction comes precisely within the terms of the statute *and there is no suggestion that the transaction was not entered into for a business purpose.*" (Emphasis supplied.)

Chester A. Souther, 39 B. T. A. 197 (January 25, 1939) was a case involving very elaborate facts, the gist of which was that General Motors Securities and Managers Securities Co. were reorganized in order that certain officers and employees of General Motors, who wished to continue in a profit sharing arrangement could so continue, and the

others who did not wish to continue could get General Motors stock. There was no possible corporate benefit or corporate purpose of the reorganized corporation in connection with the reorganization, which was undertaken and carried through solely for the stockholders' benefit. The reorganization was approved by the Board because it was a genuine transaction, not undertaken solely to avoid tax. In so approving it, the Board said (p. 216):

> "* * * It is thus apparent that the plan devised and executed was prompted *not only by a motive of tax avoidance*, but for the purpose of providing a means whereby those stockholders who preferred to maintain their investments in a holding company might do so, while others might liquidate and acquire the direct ownership of General Motors common stock if they so desired. In this connection it is noted that more than two million of the class A shares were still outstanding on December 31, 1935. Certainly on these facts it can not be said, as it was in Gregory v. Helvering, supra, that 'the whole undertaking * * * was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else.' * * *
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> "It is, of course, true that the organization and maintenance of a pure holding company do not ordinarily serve a business purpose comparable to the purposes of commercial, industrial, trading, or financial organizations and similarly a difference in business purpose exists in the reorganization of a holding company. But where the purposes which prompt the organization of a holding company in the first instance are inherent in the reorganization of such company and the plan followed is within the wording of the statute, there is, in our opinion, no basis or ground for applying the doctrine of Gregory v. Helvering, supra, to such a reorganization and to hold, as the petitioners here contend, *that it was solely a device to avoid tax.*" (Emphasis supplied.)

A similar case was *Elmer W. Hartzell*, 40 B. T. A. 492 (August 23, 1939), the facts of which are substantially those in the hypothetical case suggested by Judges Goodrich and Maris at the end of their dissenting opinion in the Court below (R. p. 140). Although it does not mention *Gregory* or the *Gregory* principle, the decision involved the applicability of the *Gregory* test. This case involved the question as to whether gain was realized in the exchange, by a group of younger stockholders with another group of the older stockholders, of common stock for preferred through a recapitalization. The general purpose of the recapitalization and of the exchange which the Board held to be a part of the reorganization (although the dissenters thought it was not, but a subsequent and independent step) was in order that the younger stockholders might end up with all the common stock and the older stockholders end up with preferred stock, both having started out with common. There was no conceivable corporate purpose or corporate benefit, unless it would be to have younger stockholders in control. The transaction was purely a shuffling of the control amongst the stockholders, effected by a bona fide recapitalization not undertaken for tax avoidance. The Board held that no gain had been realized.

In *C. A. Munroe*, 39 B. T. A. 685 (April 5, 1939) the Board, discussing the *Gregory* doctrine, said:

> "it is not necessary that the business purpose of every corporation shall be strictly commercial," or that the reorganization, in order to be tax-free, must be profitable, provided the reorganization is a genuine one and not a sham.

In *J. D. and A. B. Spreckels Co.*, 41 B. T. A. 370 (February 14, 1940), the Board extended the *Gregory* principle by analogy, holding that where one corporation acquired all of the stock of another corporation which had a large loss and had ceased doing business, in order to include this loss in the acquiring corporation's consolidated return, this

could not be done where the only purpose of acquiring the stock was to reduce its tax.

Again, in *Ardbern Co. Ltd.*, 41 B. T. A. 910 (April 23, 1940) the Board held ineffective the organization of a Newfoundland corporation which participated in a reorganization for the purpose of eliminating taxes.

In *Peck and Peck*, 42 B. T. A. 651 (August 29, 1940) the Board sustained a recapitalization against the contention of the Commissioner that the *Gregory* case was applicable, although the only conceivable purpose and effect of the reorganization was to benefit the stockholders and no benefit to the corporation was pointed out.

In *Lyon, Inc.*, 42 B. T. A. 1094 (October 29, 1940) the Commissioner contended and the Board held that in a conduit corporation case like *Gregory* the Commissioner could, if he wished, elect to treat the case as involving a tax-free reorganization. On appeal, however, the Circuit Court of Appeals for the 6th Circuit (127 F. (2d) 210, April 13, 1942) said that the Commissioner had no right so to elect and that if the *Gregory* case was properly applicable, it must be applied.

In *Anna V. Gilmore*, 44 B. T. A. 881 (July 3, 1941), the Board held, in a case subsequently affirmed by the Circuit Court of Appeals for the Third Circuit, (130 F. (2d) 791) that a merger of a holding company with a subsidiary constituted a tax-free reorganization, although the parent corporation held but a bare majority of the stock of the subsidiary which merged with it; this, despite the dissent by Judges Turner and Hill on the ground that the *Gregory* case was applicable and that the transaction really constituted a liquidation. A similar later decision is that in *George Palen Snow*, Docket No. 107,390 Memo. Decision, December 10, 1942 (CCH Decision No. 12,908 (M)).

In *Isaac W. Frank Trust of 1927*, 44 B. T. A. 934 (July 9, 1941) the Board held, despite the Commissioner's argument as to the applicability of the *Gregory* case, that the partnership there involved had been formed, not merely

to avoid taxes, but also for a business purpose, to relieve certain trustees of the possibility of surcharge. Judge Mellott dissented on the ground that under the rationale of the *Gregory* case the partnership should be disregarded.

In *Edith B. Bass*, 45 B. T. A. 1117 (December 30, 1941) a corporation had outstanding 600,000 shares of common stock without par value and with a stated value of $6,000,000, all held in a voting trust. In order to provide more marketable shares and thus satisfy the stockholders, and to provide additional marketable shares which the corporation might sell, a plan was devised and authorized by which the capital was increased from 600,000 shares, without par value, to 50,000 shares of $100 par value preferred stock and 600,000 shares of no par value common stock. 300,000 shares of common with a stated value of $3,000,000 were exchanged for 30,000 shares of the new preferred stock of par $3,000,000 and the remaining 300,000 shares of common stock were increased to 600,000 shares. The effect of this obviously was to put the 30,000 shares of preferred stock in the hands of the same stockholders who ended up with exactly the same amount of common stock with which they began and the preferred stock in addition. The Board held that the transaction was in essence a dividend of the preferred stock, since the stockholders ended up with exactly the same amount of common stock with which they began. The case was reversed, however, on appeal (129 F. (2d) 300) on the ground that no surplus was recapitalized. The Board did not rely on the distinction between a corporate and a stockholder's purpose, or even mention this possible distinction.

Jacob Fischer, 46 B. T. A. 999 (April 28, 1942) did not refer to the *Gregory* doctrine but involved a set of facts where 7,000 shares of common of $100 par value, total $700,000, were converted into 35,000 shares of common with par $10, $350,000, and 14,000 shares of new preferred, par $25, $350,000, a total of $700,000. One, Henry Fischer, had owned over 52% of the outstanding stock and on his death

it was desired to guard against the change in management by a sale of the estate's stock. The Board of Tax Appeals relied on the fact that the transaction resulted in a wider distribution of the company's stock, the number of its stockholders having been increased from 11 to 300, but from a reference to the facts it appears that this distribution was effected, not by a sale of stock by the corporation, but by the stockholders. The Commissioner contended that the preferred stock was issued as a dividend, but the Board refused to support this contention, holding that there was a business purpose in the recapitalization in effecting a wider distribution of the stock, to secure a ready market, with an assurance against the change of control. It is noteworthy that the Board, in holding that the recapitalization was *bona fide* and not lacking in any business purpose, did not use the phrase *corporate* business purpose.

It is impossible to conclude, as a matter of fact, that it benefits a corporation to have the holder of a large block of its stock sell this to two or three hundred different holders. True, this may possibly benefit the corporation in some cases and, on the other hand, it may be more to its advantage to have one large stockholder than two or three hundred small ones. The decision, as well as the other similar decisions, merely emphasizes the unsoundness and the lack of practical common sense inherent in the Tax Court's new theory.

Clarence J. Schoo, 47 B. T. A. 459, (August 5, 1942) was a recapitalization case in which outstanding preferred and no par common stock were exchanged for new par value common and 25 year debenture bonds. The only conceivable purpose benefiting the corporation was in making available to the corporation unissued 5% preferred stock instead of 7%, which the president suggested would be more valuable for the payment of dividends on the common, and in the possible deduction of the interest on the debentures in assessing taxes. The Board held that it was a tax-free reorganization, saying (p. 462):

"There is nothing in the circumstances to invite the doctrine of *Gregory v. Helvering*, 293 U. S. 465. *No transaction was impending which threatened a tax on any of the participants. The recapitalization is not a sham or an artificial detour around a taxable event.* There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course." (Emphasis supplied.)

There was no statement, even in this late case, as to the necessity of a *corporate* business purpose as distinguished from a *stockholders'* purpose.

Edgar M. Docherty, 47 B. T. A. 462, (August 5, 1942) was also a case involving a recapitalization, the company being a small one of which the three officers owned all but 20 shares of the stock. The recapitalization consisted in the change of capital stock to 500 shares of no par value and the issue of $75,000 5% 20 year debenture certificates, subordinated to the claims of other creditors. There was suggested no conceivable *corporate* purpose, the sole benefit being to the three *stockholders*. The Board of Tax Appeals refused to sustain the Commissioner's contention that the *Gregory* case was applicable, saying: "the recapitalization was a bona fide readjustment of the corporation's financial structure for a legitimate business purpose."

It will be noted that the Board did not say for a legitimate *corporate* purpose, its expression "for a legitimate business purpose", obviously meaning "not undertaken solely for tax avoidance."

In *Capento Securities Corp.*, 47 B. T. A. 691 (September 22, 1942) there was also involved a recapitalization which the Board sustained and which was, in turn, sustained by the Circuit Court of Appeals, (140 F. (2d) 382) on the ground that the Board was *unable to find* that the

procedure adopted was without justifiable business foundation. The Board said (p. 694):

> "It is hard to see an actual realization of gain which is escaping tax by a factitious device, like that attempted in the *Gregory* case."

Here, it will be noted, both that the Board does not assert the necessity of a *corporate* business purpose and that it apparently treats the recapitalization as valid unless it *affirmatively* appears that it was *not* undertaken for a legitimate business purpose (i. e., a purpose other than tax avoidance).

The latest decision by the Tax Court, prior to Judge Harron's invention of the corporate business purpose theory, is *Annis Furs, Inc.*, Docket No. 110,894, (January 28, 1943) (CCH Decision No. 12945 (M)), the same recapitalization coming before the Court in *Annis Furs, Inc.*, 2 T. C. 1096 (November 30, 1943).

In the first case the question was as to the disallowance of a deduction claimed by the corporation for the interest paid on its 6% 20 year gold debentures, which it had issued in a recapitalization in exchange for 6½% preferred stock. The Commissioner disallowed the deduction on the ground that there was no business purpose justifying the recapitalization. The taxpayer testified and contended that the holders of the preferred stock wanted a permanent income, if possible, and the Commissioner contended that this was a reason personal to the stockholders and not a corporate purpose. Judge Black declined to make a finding as to what purpose actuated the exchange, but went on to say:

> "*If a corporation and its preferred stockholders for reasons satisfactory to themselves* agree upon an exchange of preferred stock for debenture bonds, then it seems to us that such is business purpose enough and we need look no further, provided of course that the obligation created by the bonds is genuine."

Subsequently, the case came up on the question as to whether the recapitalization constituted a tax-free reorganization. In holding that it did, the Tax Court said (p. 1098):

> "It can not be said, however, that this recapitalization served no reasonable or legitimate business purpose, for the reduction of the corporation's periodic charge from 6½ percent, as the dividend was under the preferred shares, to 6 percent, as the interest became under the debentures, *was a sufficient financial advantage to explain and justify the change.* This Court said as much (although not definitively) in a memorandum opinion (appeal dismissed C. C. A., 6th Cir., October 9, 1943) relating to the petitioner's own 1940 income tax and its right to deduct the debenture interest. The statement by petitioner's president that from the standpoint of the shareholders the exchange may have satisfied their desire for 'a permanent income if possible' does not detract from the *reasonableness as a purpose of the corporation's reduction of its interest charge.* We therefore hold that the exchange occurred in a reorganization, as defined in section 112 (g) (1) (E) of the Statute; and that, by section 112 (b) (3), no gain may be recognized. The exchange was not a distribution of earnings and profits but was a recapitalization thereof." (Emphasis supplied.)

Here, it will be noted that the change was a substitution of a fixed interest charge on 6% bonds for 6½% preferred dividend charges, which would be payable only out of profits.

In *The Humko Co.*, Docket No. 112235, 79, Decided December 11, 1943 (CCH Memorandum Decision No. 13,642 (M)), Judge Harron of the Tax Court disallowed a claimed deduction for interest on alleged loans made by two stockholders, which loans were subordinated to creditors, Judge Harron holding that this was a sham and that these were

not real loans. She pointed out that the transaction served no business purpose to the petitioner, which purported to borrow from its two stockholders at the rate of 6% when it could borrow from the bank at 3%, and held that the arrangement was unreal on its face. She then said:

> "Kopald testified that the arrangement was for the purpose of giving each stockholder some independent means outside of their proprietary interests in petitioner as evidenced by stock ownership. If that was the purpose, it does not aid petitioner. *It has been said frequently* that arrangements to suit the personal convenience of stockholders cannot be held to relate to the business and business purposes of a corporation, *where no business purpose to the corporation is served.*
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> "The real question is whether or not there was any substance to the entire transaction. The evidence shows abundantly that there was not." (Emphasis supplied.)

As heretofore stated, this statement constituted, it is believed, the birth of the corporate business purpose doctrine. Judge Harron referred to no decision in support of her statement that "it has been said frequently", and none has been found.

Louis Wellhouse, Jr., 3 T. C. 363 (February 28, 1944) was the first recapitalization case in which the Court held that corporate business purpose, as distinguished from stockholders', was essential, and that no corporate business purpose was there present. In that case, preferred stock had been issued in exchange for common stock, in order that the petitioners might pay their private debts. The Tax Court held that the real purpose was to permit the stockholders to pay off their debts, and that it was immaterial that in so doing this it was desired to retain the control of the corporation in the petitioners. The Court pointed out that the sale of the stock necessary to pay the stock-

holder's indebtedness would not have deprived petitioners of control, and

> "The record fails to establish any need in the corporation itself, as distinguished from the petitioners-stockholders for funds at the time of the change in corporate structure."

This case, however, was decided for the taxpayer on other grounds.

Arthur J. Hooks et al., Docket No. 109416, 27—decided August 22, 1944 (CCH Decision No. 14,111 (M)), involved an elaborate recapitalization, the retirement of two classes of preferred shares on which there were arrears of dividends and the issue of debentures in exchange for the preferred. Judge Leach, of the Tax Court, in upholding the recapitalization found that there were seven different business purposes, a number of which were clearly in the interest only of the stockholders and not of the corporation.

The foregoing constitute all the pertinent decisions by the Tax Court which we have found, prior to the adoption by a majority of the Tax Court of the corporate business purpose test in the case at bar, as well as in the *Adams* case (4 T. C. 1186, April 26, 1943; 5 T. C. No. 40, June 29, 1945) and in *Marion Heady*, Docket Nos. 5812 and 5813, decided July 24, 1945, (CCH Decision No. 14,702 (M)).

It thus clearly appears that the corporate business purpose test was invented by the Tax Court as a construction of the *Gregory* decision, almost nine years after the rendering of the latter, and despite numerous decisions by the Board of Tax Appeals and by the Tax Court in the interim, wholly inconsistent with that test. Furthermore, from an examination of these cases, it is clear that the distinction between the benefit to the corporation and the benefit to the stockholders from a recapitalization is a wholly impractical and, in most cases, an imaginary one. A corporation is, in reality, the stockholders, conducting business in a specified statutory form. The only reason or excuse

for the existence of a corporation is to further the interest of the stockholders. In reality, whatever is in the interest of one is in the interest of the other. While theoretically there might be a distinction between the *motive* of the corporation and the *motive* of the stockholders, once we eliminate motive, as the Court below did in the *Gilmore* case (see note 8 of the original opinion of the Court below, R. p. 111) the distinction becomes wholly impractical and unworkable.

There have been many cases in which the sole or primary objective in a recapitalization has been the elimination of the accumulated and unpaid dividends on preferred stock. See for example:

Okonite Co., 4 T. C. 618 (January 29, 1945); affirmed 155 Fed. (2) 248 (April 18, 1946); cert. den. October 28, 1946;

Globe-News Publishing Co., 3 T. C. 1199 (August 4, 1944);

Knapp Monarch Co., 1 T. C. 59 (November 18, 1942), affirmed 139 F. (2d) 863 (C. C. A. 8th, January 17, 1944);

Elizabeth Morainville, 46 B. T. A. 753 (January 26, 1942), reversed 135 F. (2d) 201 (C. C. A. 6th, April 7, 1943);

Skenandoa Rayon Corporation, 42 B. T. A. 1287 (November 26, 1940), affirmed 122 F. (2d) 268 (C. C. A. 2nd July 31, 1941), cert. den. 314 U. S. 696 (December 22, 1941);

South Atlantic Steamship Line, 42 B. T. A. 705 (September 20, 1940);

Lelia S. Kirby, 35 B. T. A. 578 (March 9, 1937), affirmed on this issue 102 F. (2d) 115 (C. C. A. 5th, March 8, 1939).

In none of these cases has it been contended that the doctrine of *Gregory v. Helvering* could apply despite the fact that the moving consideration is obviously to benefit the

common stockholders, the accrual of preferred dividends not being a liability to the corporation, but merely a deterrent from future common dividends. In fact in many of these cases the corporation, after the recapitalization, has bonds outstanding in the amount of the accrued dividends, and has reduced its net worth accordingly, which is consistent only with a stockholder as distinguished from a corporate benefit. See for example:

Globe-News Publishing Co., 3 T. C. 1199 (*supra*) (scrip payable in 25 years with interest at 4%);

South Atlantic Steamship Line, 42 B. T. A. 705 (*supra*) (25 year 5% debentures and scrip);

Lelia S. Kirby, 35 B. T. A. 578 (*supra*) (15 year 6% first mortgage gold bonds).